Islamic Banking and Finance in South East Asia (Part 2)

– Its Development and Future

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Issues and Challenges

At present, Islamic financial markets are highly segmented and differ considerably between nations. This has arisen out of divergent interpretations of the Shari'ah, differing domestic legal systems, and recourse to different financial instruments. However, globalisation is bringing about standardisation of financial products. Moreover, adherence to international regulations from designated Islamic institutions such as the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)[1] and the Islamic Financial Services Board (IFSB), and, where relevant, secularist institutions such as the International Monetary Fund (IMF) and Bank of International Settlements (BIS), would place Islamic finance on par with conventional finance in the pursuit of best practices.

Islamic financial instruments add considerable variety and choice not only for Muslims but also non-Muslims as well, giving Islamic finance a truly pluralist flavour. Religious orientations aside, all those who do care about the ethical content of their financial transactions are likely to be inclined towards Islamic finance in that there is much more to Islamic finance than the mere elimination of *riba* or interest. As Islam prohibits transactions of a fraudulent nature, for it to be truly Islamic, financial instruments must be free from all forms of deceit, exploitation and ambiguity. Such universal values mean a lot to many people regardless of their religious backgrounds and the number of non-Muslims using Islamic financing is on the rise. Thus, for example, about one-fifth of the HSBC Amanah financing in Malaysia caters to non-Muslims.[2] It is also understood, that as much as 75% of consumer Islamic Banking customers in Malaysia are non-Muslims.

As Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia believe, at present, the absence of a truly global Islamic financial system based on Shari'ah principles, means that the continued growth and development of Islamic banking and finance is somewhat haphazard. In this last respect, governments could assume a more active role in promoting the development of Islamic financial systems. In particular, they need to provide the necessary infrastructure that will favour the growth of Islamic banking in their respective countries and this means putting in place, from the outset, a comprehensive, Shari'ah-compliant, legal and regulatory framework. Compliance with Shari'ah principles is not, however, in itself sufficient to guarantee the future success of Islamic banking and finance. In the long run, the sustainability of Islamic banking rests on satisfying the demand for quality in the products and services that Islamic finance can offer. This is the ultimate challenge for Islamic banking and finance, namely to be able to provide a comprehensive range of Islamic financial products and services that are not only Shari'ah compliant, but also innovative and competitive with conventional financial instruments.[3]

Islamic Banking Malaysia

Islamic banking has been available in Malaysia (first market mover) since 1983 and to date, Islamic banking products are available at two full-pledge Islamic banks as well as at all commercial and

merchant banks in Malaysia. Even so, after two decades, these products are now starting to gain widespread acceptance by customers. As at June 30, 2003, Islamic banking assets accounted for 9.4% or RM75.5 billion of the banking system in Malaysia. Deposits and financing accounted for 10% and 9% respectively, while takaful assets accounted for 5.3%. Deputy Finance Minister Datuk Shafie Mohd Salleh regards the the Financial Sector Masterplan's target for the Islamic Banking and takaful industry to achieve 20% share of the total banking system by 2010 to be within reach.[4]

Islamic Banking in Malaysia is supported by IFSB, an association of central banks, monetary authorities and other institutions that regulate the Islamic financial services industry. Established in Kuala Lumpur in November 2002, the board's members include a strong list of international players.

Today, Malaysia is reported to have one of the most developed interest-free financial system in the world. Beside the Interest-free Banking Scheme, there is an Islamic debt securities market developed in 1990 and an Islamic equity market, both operating since 1995; the Islamic Interbank Money Market was established in 1994.[5]

Islamic Banking Indonesia

Islamic banking only became available in Indonesia (sleeping giant) in the mid 1990's. While it is now a relatively small percentage of overall banking, it is growing rapidly as Indonesian Muslims embrace Islamic principles. In 2003, demand for Islamic banking grew by 85 per cent to seven and a half billion Rupia, or $200 billion. Not to be left out, some established banks are now also offering Islamic financial products, with the emphasis on investments only being made in *Halal* goods and services.[6]

The progress of Islamic banking in Indonesia is impeded by the lack of comprehensive and appropriate framework and instruments for regulation and supervision, limited market coverage, lack of knowledge and understanding by the public, lack of efficient institutional structure supporting efficient Islamic banking operations; operational inefficiency, domination of non-share base financing and limiting capability to comply with international Islamic financial standards.[7]

Islamic Banking Brunei

Brunei (niche market player) has been keenly promoting Islamic banking as an alternative to conventional banking during the past decade. There are three Islamic financial institutions in the country: the Islamic Bank of Brunei (IBB), Tabung Amanah Islam Brunei (TAIB or Islamic Trust Fund of Brunei) and Islamic Development Bank of Brunei (IDBB). The latter, wholly owned by the government, converted to the Islamic system in late 2000.

Islamic Banking Singapore

Islamic banking is at its infancy in Singapore (regional Islamic financial hub), due largely to a lack of awareness and a small domestic market that has not attracted the major bankers. OCBC is the only active player in the market, offering two Islamic deposit accounts in the consumer market. But it has

failed to replicate the success it has had in Malaysia, where it is the second foreign player in the field with some RM457 million (S$204 million) in Islamic banking loans.[8]

The Singapore government intends to promote Islamic banking products to expand its reputation as a financial hub, and will collaborate with countries such as Malaysia and Brunei in this area.[9]

Conclusion

Some of the problems identified by Islamic finance commentators are now being overcome. Issues such as the development of marketable instruments, organising financial markets and creating tools for risk management were identified as key challenges. Progress has been made on all of these fronts. The development of Islamic securities can reduce some categories of risks; yet at the same time encourage other types of desirable risk taking. The introduction of bills, bonds and notes that can be traded reduces the liquidity risk problems. Banks can move some liquidity from cash into Islamic securities, as the latter constitute an acceptable risk.

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[1] A group which codified Shari'ah rulings into a set of industry standards.
[2] Shahul Hameed Bin Hj. Mohamed Ibrahim, "From Conventional Accounting To Islamic Accounting: A Review of the Development Western Accounting Theory and Its Implications for and Differences in the Development of Islamic Accounting" (1997) <http://vlib.unitarklj1.edu.my/htm/account1.htm> at 17 June 2004.
[3] "Building a comprehensive Islamic financial system - new financial opportunities", Keynote address by Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia, at the Institute of Islamic Banking and Insurance's International Conference on Islamic Insurance, London, 26 September 2003.
[4] Bank Islam Malaysia Berhad, *Islamic Banking Sector Sets Target* (2003) <http://www.bankislam.com.my/berita_Ogos19_e.htm> at 17 June 2004.
[5] Sadna Saifuddin, Kuwait Finance House Secures Islamic Banking Licence (2004) New Straits Times (M) Berhad <http://www.nst.com.my> at 17 June 2004.
[6] Hamish Robertson, Shari'ah Banking Grows in Indonesia (2004) ABC Online Home <http://www.abc.net.au/am/content/2004/s1130581.htm> at 17 June 2004.
[7] "The Blueprint of Islamic Banking Development in Indonesia", Bank Indonesia, September 2002
[8] Val Chua, "Wooing the Islamic Billion$", *Today* (Singapore), 24 September 2004
[9] Siow Li Sen, "S'pore Can Add Value in Developing Islamic Finance", *The Business Times* (Singapore), 25 September 2004.